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TAGS: [EFIN](#) [ECON](#) [PGOV](#) [PREL](#) [BR](#)
SUBJECT: ICE THINNING UNDER BRAZILIAN FINANCE MINISTER PALOCCI

REF: A) BRASILIA 0502
B) BRASILIA 0416
C) BRASILIA 0353
D) 05 BRASILIA 3349 and previous

Classified by Deputy Economic Counselor J. Andrew Plowman,
resons 1.4 (b) and (d).

11. (C) Summary: The Congressional Investigative Commission (CPI) on Bingo Houses, which is conducting hearings into allegations of corruption in the Lula government, heard testimony on March 16 from a gardener/handyman who said Palocci had frequently visited a Brasilia house where several of his advisors are alleged to have conducted corrupt dealings. The CPI hearings were cut short by the arrival of a Supreme Court injunction, obtained by the ruling Workers Party (PT), which claimed the hearing violated Palocci's privacy rights. In contrast with previous CPI hearings on Palocci's activities, the opposition social democratic party (PSDB), which this week announced that Sao Paulo Governor Geraldo Alckmin would be its presidential candidate, did not try to shield Palocci and instead called for his departure. Palocci's international affairs advisor, who two weeks ago categorically denied that Palocci would depart the Ministry before the end of Lula's mandate, was far less certain in a discussion with Econoff on March 17.

12. (C) The markets are taking the news in their stride, as CSFB Chief Economist Nilson Teixeira told us that there is little expectation Lula would shift economic policies prior to the elections, even if Palocci were to leave. While Lula's commitment to macroeconomic orthodoxy is unlikely to falter, we have less faith in his March 16 statement that Palocci will stay on the job. The PT's ham-handed injunction caper has created the distinct impression that Palocci has something to hide and weakened him politically. While Lula may soon begin wondering whether Palocci's presence has not now become a bigger liability

than asset, we do not expect an immediate change. End Summary.

New Witness Contradicts Palocci Denials

¶3. (SBU) Among the many allegations of corruption and/or involvement in influence peddling that have been leveled against Minister Palocci (Ref D and previous), one set revolves around the activities of a group of advisors who supposedly engaged in influence peddling and corrupt contracts. The group is alleged to have conducted these corrupt dealings at a Brasilia house rented by one of these advisors. Palocci testified to the CPI that he never went to the house. Costa and a driver for one of Palocci's aides both have contradicted that testimony.

¶4. (SBU) Costa's March 16 testimony to the CPI was cut short by the arrival of an injunction from the Supreme Court, obtained at the behest of the PT party, which claimed the hearings would violate Palocci's privacy rights. The PT justified the injunction on the grounds that Costa's testimony might touch on intimate details of Palocci's alleged activities at the house, since other witnesses have claimed that Palocci's advisors frequently brought prostitutes to the premises for parties. Even though it alleges the claims to be false, the PT argued that the testimony stood to violate Palocci's privacy rights.

Opposition no longer Shielding Palocci

¶5. (C) In contrast with previous CPI sessions on the allegations surrounding Palocci, members of the opposition PSDB and PFL (Liberal Front Party) no longer sought to shield Palocci. In

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meetings prior to yesterday's CPI session, PSDB Party leaders had told PolCons that in retrospect, their decision to spare Palocci -- motivated by a desire to act as good citizens and preserve Palocci's fiscal policies -- had been a strategic error. The PSDB and PFL changed course at the March 16 hearing and in its aftermath, called for Palocci's departure and sharply criticized the PT decision to seek the Supreme Court injunction.

PSDB party president Tasso Jereissati termed Palocci's tenure "unsustainable." Even some members of the PMDB party, nominally allies of the PT, jumped on the bandwagon, calling on Palocci to leave office.

¶6. (C) Throughout the roller-coaster ride of the Palocci corruption allegations, the ministry's international affairs advisor, Sergio Bath (please protect), repeatedly has assured us that Palocci has no intention of leaving the ministry. On March 3, he categorically denied reports published by the press that Palocci would leave to be Lula's campaign coordinator and stated that Palocci expected to stay in office for the remainder of Lula's term. In a March 17 conversation about the most recent developments, he was far less categorical, saying that he anticipated no change over the course of the next few days.

Markets Calm, Expect no Change

¶7. (SBU) CSFB Chief Economist Nilson Teixeira told Econoff March 17 that financial market participants appear not to be concerned about the latest twists in the Palocci saga. The most likely scenario, he stated, is that Palocci would remain on the job for the rest of Lula's term. Even were Lula to opt to replace Palocci, there was little chance he would change economic policies this late in the game. The economy was Lula's biggest success story going into the election, Teixeira pointed out. Even were Palocci to be replaced with someone like Senator Aloizio Mercadante, a senior PT member who has at times questioned the degree of the finance ministry's zeal in pursuing elevated primary surpluses, Teixeira believed there would be policy continuity for the remainder of Lula's term.

¶8. (C) Comment: The political equation surrounding Palocci has changed fundamentally given Lula's (entirely unexpected)

resurrection in the opinion polls and the PSDB's decision to nominate Sao Paulo Governor Alckmin as its presidential candidate; the opposition no longer has any incentive to spare Palocci. Moreover, the ham-handed way in which the PT sought to stop yesterday's testimony with a supreme court injunction has created the distinct impression that Palocci has something to hide. Palocci has reasons to want to stay on the job, as his ministerial rank means that only the Supreme Court can prosecute him. Moreover, Lula has no obvious candidate to replace Palocci, for few people would be acceptable both to the markets and Lula's left wing. Lula must nevertheless be wondering whether keeping Palocci will not become an increasing liability, presenting the opposition with an easy target as the election season begins. We do not expect an immediate change, however, as the GoB evaluates the political fallout of yesterday's fiasco and, just maybe, begins to plot Palocci's exit strategy.

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